

## Canso Credit Income Fund

### 1) **Description of Fund investment employing shorting:**

The prime investment objective of the CCIF is provide income from credit instruments at an acceptable level of risk. The fund can employ shorting to hedge both credit and interest rate risk. Currently the fund has limited short credit positions as Canso believes that the current wide level of credit spreads is very attractive. Most of the CCIF long credit positions are currently hedged by shorting long Canada bonds. This means the fund does not assume interest rate risk on these positions.

While security selection is the major source of differentiation for the Fund, the emphasis on the bottom up selection of corporate bonds also offers considerable protection in a rising interest rate environment. Corporate bonds normally have a higher yield than government bonds. This means that over long periods, the extra corporate yield spread should add to the return of the Fund and reduce the negative impact of rising interest rates. Corporate bond yield spreads (the extra yield above governments) tend to reduce or “narrow” with rising interest rates. This results from an improving economy and therefore better credit metrics for corporate issuers.

Canso currently believes that interest rates are historically low due to intense market fears of economic and financial distress. At the same time, Canso believes that the credit yield spread on many long term corporate bonds is attractive on a historical basis. Canso has structured the Fund to capture the credit yield spread of certain long-term corporate bonds while hedging interest rate risk by selling similar maturity Government of Canada bonds short. This would help to protect the Fund from the adverse effects of rising interest rates on the market values of the long positions if interest rates were to rise. Additionally, in a period of low interest rates with accompanying wide credit spreads (as is the case today) the portfolio will collect the yield spread on the hedged long corporate bond positions (the term hedged in this instance means that there is a paired short position of roughly equal value and duration “hedging” the risk of rising interest rates). The proceeds received from shorting the Government of Canada bonds is also reinvested in shorter term or floating rate bonds and the portfolio benefits from the additional yield received on these positions.

## The path of monies invested in CCIF – Example 1

LONG	SHORT	LONG	
Buy	Sell	Buy	NET RESULT
<b>\$1 million</b>	\$1 million	\$1 million	
<b>Long Shaw Communications Bond (Nov 9, 2039)</b>	Government of Canada Bond	Manufacturers Life Insurance	Excess cash available providing additional margin*
<b>390 spread over Canada</b>	June 1, 2037 Yield of 2.7%	November 18, 2016 (spread of 280)	
<i>Reason for purchase</i>	<i>Reason for Sale</i>	<i>Reason for purchase</i>	
<b>Solid credit metrics and very attractive yield Spread</b>	Hedge interest rate risk of long credit position	Reinvest proceeds of short Canada bond in good value short term credit to increase yield of portfolio	
<b>-\$1.0 million</b>	+\$1.0 million	-\$1.0 million	Net Assets of \$2 million invested with \$1.0 million of capital
<b>Yield 6.6%</b>	Yield of 2.7%  +0.3% cost of borrowing  Cost of 3.0%	Yield of 4.2%	Portfolio Yield = 7.8%
<b>Collect 6.6%</b>	Pay 3.0%	Collect 4.2%	Portfolio Yield = 7.8%
<b>Duration</b>	Duration	Duration	Duration
<b>12.5</b>	15.9	4.4	1.0

\* Not all proceeds from the short sale of the government of Canada bonds are typically reinvested and excess cash is maintained in the fund. As of December 31<sup>st</sup>, 2011 cash and highly liquid assets in the fund are valued at \$74 million.

*For example:* We own a position in Long Shaw Communications Inc. bonds (6.75% November 9, 2039) which are currently trading at a spread above government of Canada bonds of 390 basis points. We purchased the bond position and have sold short an equivalent amount and duration government of Canada bond. The fund is responsible for semi-annual interest payments on the Canada bond (approximate payout is 2.7%), with this pair of trades we pick up the spread between the Canada and the Shaw bond.  $6.7 - 2.7 = 3.9$ . In addition we receive proceeds from selling short the Canada bond which we can reinvest in shorter term or floating rate corporate bonds such as Manufacturers Life Insurance.

## The path of monies invested in CCIF – Example 2

LONG Buy	SHORT Sell	LONG Buy	NET RESULT
<b>\$1 million</b>	\$0.63 million	\$0.63 million	
<b>Long Shaw Communications Bond (Nov 9, 2039)</b>	Government of Canada Bond	Government of Canada T-Bill	Excess cash available providing additional margin*
<b>390 spread over Canada</b>	June 1, 2041 Yield of 2.6%	February 16, 2012 Yield of 0.8%	
<i>Reason for purchase</i>	<i>Reason for Sale</i>	<i>Reason for purchase</i>	
<b>Solid credit metrics and very attractive yield Spread</b>	Hedge interest rate risk of long credit position	Reinvest proceeds of short Canada bond in highly liquid short term security	
<b>-\$1.0 million</b>	+\$0.63 million	-\$0.63 million	Net Assets of \$1.63 million invested with \$1.0 million of capital
<b>Yield 6.6%</b>	Yield of 2.6% +0.3% cost of borrowing Cost of 2.9%	Yield of 0.8%	Portfolio Yield = 5.3%
<b>Collect 6.6%</b>	Pay 2.9%	Collect 0.8%	Portfolio Yield = 5.3%
<b>Duration</b>	Duration	Duration	Duration
<b>12.5</b>	18.5	0.1	0.9

\* Not all proceeds from the short sale of the government of Canada bonds are typically reinvested and excess cash is maintained in the fund. As of December 31<sup>st</sup>, 2011 cash and highly liquid assets in the fund are valued at \$74 million.

## 2) When CCIF is short a government bond, who is responsible for the coupon payment on it?

In a short sale, the portfolio borrows government bonds from other investors. The fund therefore pays the coupon payments on the short Canada positions as illustrated above.

## 3) From the short proceeds, how much is going towards buying attractive corporate bonds at wide spreads? How much is going towards paying the distribution?

The portfolio typically invests the proceeds of its short government sales in corporate bonds. At December 31<sup>st</sup>, 2011 it held almost \$37 million of its assets in Government of Canada T-Bills as a liquidity reserve. The cash flow received from the long positions substantially exceeds the cash interest payments on the short positions and is used to fund the monthly distribution of 0.4% (1/12 of 5%). In addition, the portfolio held approximately \$45 million liquid corporate bonds that could be used to fund the distribution.

The primary benefit of the shorting is that it allows the fund to invest in very attractive long corporate bonds at historically wide spreads without exposing the fund to an overall rise in long rates. The fund can capitalize on the wide spreads and not be exposed to the potential downside of an overall increase in long rates. Furthermore the fund can fully participate in the spread narrowing that we believe will occur.

Bond	Yield	Duration	Spread	Spread change	Price change	1 Year Holding Period Return*
<b>Shaw 2039</b>	6.6%	12.5 years	390 bps	(100)	+12.5%	+19.3%
<b>Manulife 2016</b>	4.2%	4.4 years	280 bps	(75)	+3.3%	+7.5%

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Estimated returns with no change in benchmark Canada bond yield.

\*Holding Period Return represents the combination of the coupon payment and capital gain from narrowing bond spreads over the 1 year period.

#### 4) What is the main risk to the portfolio – taking the double hit on both longs & shorts?

The portfolio is designed to maximize income at an acceptable level of risk. Canso does not try to anticipate the course of interest rates and thus “hedges” the interest rate risk of longer term bond positions, when appropriate.

As a result of the hedging of interest rate risk, the remaining risks to the portfolio are credit risk and market risk.

Credit risk reflects the potential for default of portfolio positions. Canso specializes in credit research and buys a wide universe of corporate bonds ranging from investment grade to distressed debt. Canso diversifies the portfolio by issuer and industry and also uses its proprietary “Maximum Loss” technique to establish the downside risk of each portfolio position.

The market risk to the portfolio comes from the risk that corporate bonds will behave differently than the government bonds they are hedged against. Corporate bonds are priced at a “yield spread” above the yield of government bonds. Yield spreads change with market conditions that incorporate risk and liquidity considerations. Yield spreads increase and decrease based on investor perceptions. They tend to be wide when the credit markets price in negative economic and financial factors.

If both long and short bond positions move by the same amount then the portfolio is “perfectly hedged”. To the extent that the long corporate bonds rise in value less than government bonds, the portfolio value declines.

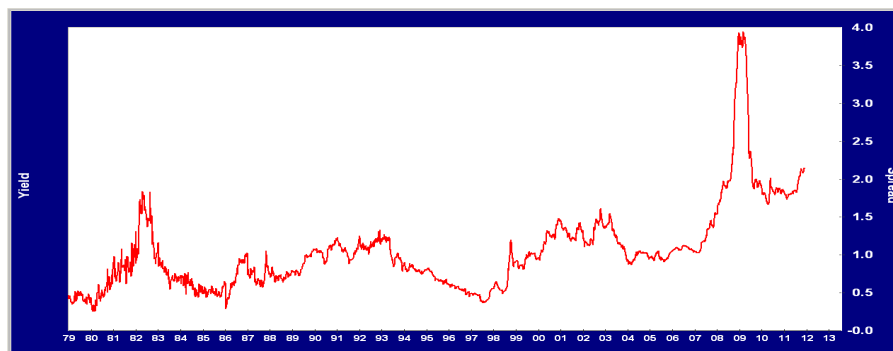
In terms of a “double hit” to the portfolio this would be a situation when yield spreads increased. This could happen if government bond yields rose or fell. For example, if Canada yields stayed the same and corporate bond spreads increased, a hedged bond position would fall in value. If Canada yields rose and yield spreads rose as well, the hedged position would fall in value. If Canada yields fell and corporate yields fell less, the current situation, then the yield spread would widen and the hedged position would fall in value.

Yield spreads on long corporate bonds are currently very high compared to historical levels as shown on the chart above. This is why the fund is invested in a large position of hedged long corporate bonds.

If the proceeds of a long Canada short sale are invested in a bond that fell in value, then this indeed would be a “double hit”. If the proceeds were invested in a Treasury Bill or a short term and high quality corporate bond, this would be very unlikely.

### Long Canadian Corporate Spreads

DEX Long Corporate versus Long Canada Index Yield Spread



*Portfolio behavior with long corporate holding hedged by selling Canada bond short in various environments*

A - Both corporate and Canada yields increase (yield spread constant)

	Yield Change	Price Change	Value	Effect on Portfolio
<b>1 million short</b>	+ 100 basis points	-15.9%	<b>-\$841,000</b>	<b>+\$159,000</b>
<b>Canada Bond</b>		-\$159,000		
<b>1 million long</b>	+ 100 basis points	-12.5%	<b>\$875,000</b>	<b>-\$125,000</b>
<b>Corporate Bond</b>		-\$125,000		
			<b>Total</b>	<b>+\$34,000</b>

B - Canada yields fall more than corporate yields. (yield spreads widen)

	Yield Change	Price Change	Value	Effect on Portfolio
<b>1 million short</b>	- 100 basis points	+15.9%	<b>-\$1,159,000</b>	<b>-\$159,000</b>
<b>Canada Bond</b>		+\$159,000		
<b>1 million long</b>	- 50 basis points	+6.25%	<b>\$1,062,500</b>	<b>+\$62,500</b>
<b>Corporate Bond</b>		+\$62,500		
				<b>-\$96,500</b>

C - Canada yields increase more than corporate yields. (yield spreads narrow)

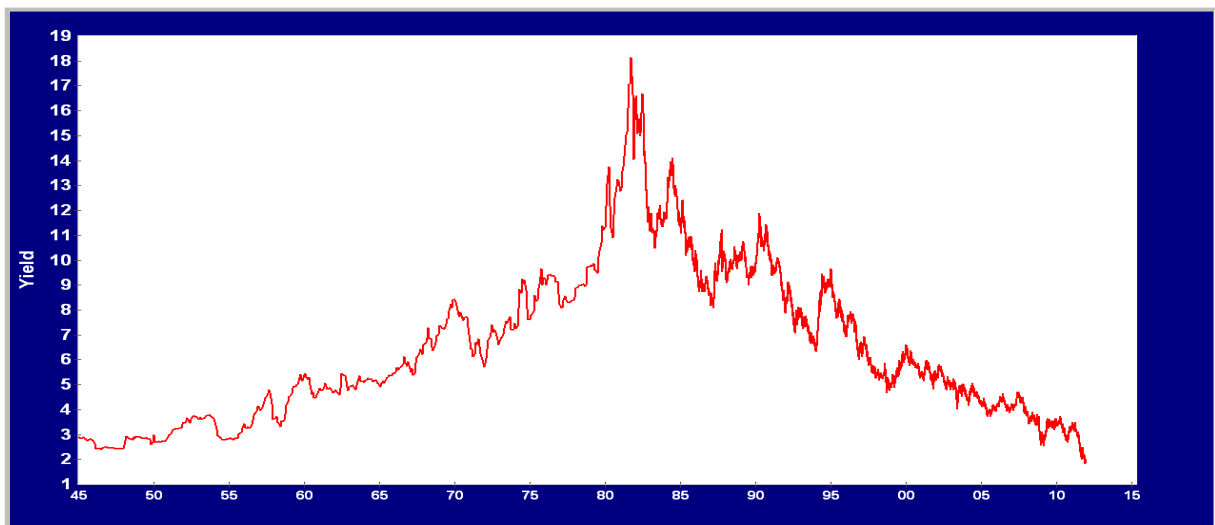
	Yield Change	Price Change	Value	Effect on Portfolio
<b>1 million short</b>	+ 100 basis points	-15.9%	<b>-\$841,000</b>	<b>+\$159,000</b>
<b>Canada Bond</b>		-\$159,000		
<b>1 million long</b>	+ 50 basis points	-6.25%	<b>\$937,500</b>	<b>-\$62,500</b>
<b>Corporate Bond</b>		-\$62,500		
				<b>+\$96,500</b>

## 5) What is the probability of rates going up?

Interest rates are at historically low levels as illustrated by the chart of the yield on the 10 year Government of Canada bond below. This bond reached its post World War II low yield of 1.8% in mid December, 2011. Canso's belief is that this extraordinarily low yield reflected the "flight to safety" from the European debt crisis. Canso also believes that the global economy will recover from the financial panic and government bond yields will eventually rise. This should also cause corporate yield spreads to narrow. In Canso's view it is unlikely that interest rates will fall further from today's current levels. Interest rates may remain at historically low levels for a period of time but the substantial yield premium of corporate bonds has priced in a considerable economic and financial downturn.

With this scenario in mind the CCIF portfolio is well positioned with a net yield to maturity of approximately 9% with a BBB+ average credit quality. When markets stabilize we believe the portfolio will profit from both coupon income and capital gains from narrowing spreads.

### Canadian 10 Year Yield Since 1945



Source: TMX Group

Likelihood	Scenario	Effect on total portfolio	Comments
6 - 24 Months	With hedge		
80%	Rates increase Spreads narrow	+ + + Very Positive	This is positive for the portfolio as spread narrowing would generally increase the prices of the corporate positions. An increase in overall rates would not affect long duration positions as they are hedged, but would have a small negative effect on unhedged short-term corporate positions.
15%	Rates stable Spreads stable	+ Neutral to Positive	If rates and spreads stay at current levels the portfolio will be dependent on the yield to maturity and coupon payments in the portfolio for return.  Portfolio Cash Yield is 8.4%*  Portfolio Yield to Maturity is 10.15%*
5%	Rates decrease Spreads Widen	- - Negative	This is a negative for the portfolio as spread widening would generally decrease the prices of the corporate positions and the drop in overall rates would be negative on the short positions.

\*Cash Yield and Yield to Maturity calculated as of December 12, 2011

**6) What is the view on managing the portfolio duration: has it evolved? If there is no growth for the next 3 years, there is no benefit to keeping duration low. Is CCIF becoming more flexible on that?**

The objective of CCIF is to generate income at an acceptable level of risk. Currently, with government bonds ranging from 1% in T-Bills to 2.5% in long Canada issues, there is very little compensation for the potential for inflation and yields to rise.

A hedged long bond position with a yield spread at 3%, with the proceeds reinvested in T-Bills at 1%, yields 3.7%. This is well above the long Canada yield of 2.5%. If there is no growth for the next 3 years, then holding an unhedged long corporate position would be better than hedging it.

“Flexibility” is a dangerous concept. The CCIF was designed with the ability to hedge interest rate risk when appropriate. Since we hold a very large position in long corporate bonds, the interest rate risk is quite large which is why we have hedged this risk. This hedged long corporate position would be superior to most other bonds in a “no growth” situation with stable interest rates.

We do not make explicit interest rate bets in the CCIF portfolio as it is meant to be a “credit income” fund. On the other hand, since the market consensus has swung from rising rates to falling or stable rates in less than a year, we think there is now considerable risk in long bonds. The only scenario which would cause us to unhedge our long corporate positions would be a severe deflationary situation as we think the market has already priced in considerable economic distress.